



The BP oil spill and the financial crisis

Summary

The 2010 BP oil spill in the Gulf of Mexico ranks among the most severe disasters in the oil and gas world, comparable to the 2008-9 financial crisis in banking. The consequences of these events have been far-reaching for their respective industries culminating in new regulations, and increased monitoring. This newsletter will examine the main BP and Basel publications and consider how useful these documents are in preventing further disasters.

Dear reader,

Two eagerly awaited publications have been made public recently: BP's investigation into the 2010 Deepwater Horizon oil spill¹ and the BIS "Basel III" documents². Although one is an industrial investigation and the other outlines a financial regulatory regime, each in its own way is about the response to a disastrous event. The common ground in these publications is that both reports are expected to lead to behavioural changes that radically lower risk. After reviewing these reports individually, we shall compare them for their respective contribution to risk management.

First impressions

BP report: The first thing we notice in the BP report is that the investigation is not only extremely concrete, it is also rather limited in scope (e.g. the sinking of the rig and the follow up of the spill are excluded). This allows for a focused report completed in a short time frame. It was created by a team of 50 experts from a variety of fields, which was requested to be formed within 24 hours of the accident. The broad range of expertise lead to highly specialised recommendations rather than general statements. This was probably the result of extensive use that was made of fault tree analysis³, which enabled a comprehensive view of all contributing factors to the accident, honouring each specialist as well as providing full coverage.

Basel III report: Basel III was already getting jocular mentions when Basel II was still being drafted. In that sense it had a bad publicity start. The first thing we notice in the Basel III documentation is that it is difficult to find out what it is. That is because it is not actually a single document. The BIS website itself² refers to "a compilation of documents that form Basel III". The set of documents clarifies (and sometimes completely re-defines) a large number of concepts. Among the redefined concepts we notice: *Capital; Minority interest; Thresholds for investments in other financial institutions; Credit Valuation Adjustments; Common Equity Tier 1; Leverage ratio; Liquidity Coverage Ratio; Liquid Assets; Systemic banks and Net Stable Funding Ratio.*

¹ The full 191 page report (not counting the appendices) can be downloaded from BPs website. The most interesting may be chapter 6 (pages 181-187) outlining all the recommendations. By implication, these are the causes or contributing factors to the accident. http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/incident_response/STAGING/local_assets/downloads_pdf/Deepwater_Horizon_Containment_Response.pdf

² The Basel III documents that can be found at: <http://www.bis.org/list/basel3/index.htm> . The best introduction is the <http://www.bis.org/press/p100726/annex.pdf>.

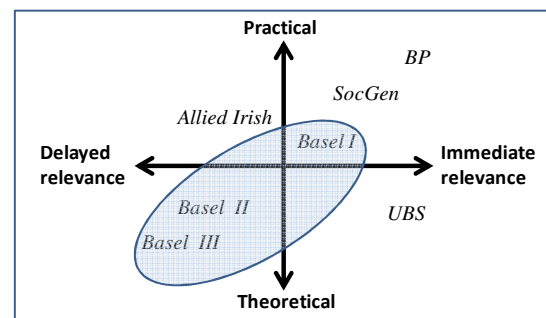
³ For a discussion on the use of fault tree analysis in risk management for financial institutions, see newsletter 9: <http://www.globalaras.com/publications.html>

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Comparison

Although regulatory documents and investigation report differ in many aspects, there are at least two dimensions along which we can compare and contrast them: how practical are they in managing risk and what is the delay time before we can expect some results? The result is striking: BP and Basel III occupy opposite ends of the spectrum in these respects. To broaden the scope a bit, we have added three more investigations into financial mishaps (the reports on the rogue trading at SocGen⁴ and Allied Irish Bank⁵ with the misjudgements at UBS⁶) and Basel I and II.

In terms of practical use (improvements that can be applied directly and that have great relevance across the industry) the BP report is a shining example, matched in part by the SocGen report. For immediate relevance it scores high. Note that not all case study investigations share that characteristic. The UBS report on asset-backed securities, was more theoretical than practical since the business had already collapsed. The Allied Irish resulted in little additional action at the time.



Three regulatory regimes and four investigation reports

The Basel papers show a clear, if disturbing trend, they are becoming increasingly more theoretical and the implementation is delayed more and more.

This combination of delay in implementing new rules and an increased theoretical focus is a real concern. When problems occur, the slower the response, the tougher the medicine needs to be, and the more theoretical the solution, the broader the sweep of requirements will be, which is why Basel III is in fact very likely to both overshoot the mark and underperform in the practical sense.

Conclusion

The BP investigation report examines the hows and whys of a specific case and has specific recommendations that are directly applicable in the industry. The Basel III regulation sets out the minimum rules and requirements to prevent financial disasters and but operates on a theoretical level with a delayed time frame. It would be useful if Basel III was augmented by a set of relevant case studies and direct recommendations from these case studies.

⁴ Société Générale, Summary of PwC diagnostic review and analysis of the action plan, by PriceWaterhouse Coopers, 23 May, 2008 http://www.accountant.nl/readfile.aspx?ContentID=38112&ObjectID=356620&Type=1&File=0000022252_SocGen_report_part2.pdf

⁵ Report to the Boards of Directors of Allied Irish Banks, P.L.C., Allfirst Financial Inc., and Allfirst Bank Concerning Currency Trading Losses, by Promontory Financial Group and Wachtell, Lipton, Rosen and Katz, March 12, 2002. http://www.aibgroup.com/servlet/BlobServer/document.pdf?blobkey=id&blobwhere=1015597173380&blobcol=urlfile&blobtable=AIB_Download&blobheader=application/pdf&blobheadername1=Content-Disposition&blobheadervalue1=document.pdf

⁶ Shareholder Report on UBS's Write-Downs, UBS, April 18, 2008. http://www.ubs.com/1/e/investors/share_information/shareholderreport.html